

## Is it a Revenue or Liability?

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### Introduction

ABC finance PLC is a leading Islamic finance provider in Sri Lanka. It provides lease, Hire purchase and loan facilities to customers. Company is using different jargons to introduce products In the Islamic unit loan lease products are called as Murabha and Ijhra respectively. Islamic finance is been conducting accordance with the principles of sharia law. Sharia law prohibits acceptance of specific interest penal interest and fees for loans. Company recognizes interest under profit share. Though company is charging and collecting penal interest for due rentals, it is not recognized to the period profit. This practice has been created an issue with accounting standers and financial reporting frame work.

### Discussion of the Issue

An example has been illuminated for the understanding. Company has given a Rs. 2,400,000 loan on 15/04/2014 for 8% interest rate and it should be repaid on 48 installments. 1st installment is due on 15/05/2014. If customer is unable to pay the installment on due date he will be charged penal interest.

#### Company policy regarding penal interest

Company has given 6 day grace period to customer to pay the installment. If customer is unable to pay within 6 days customer is charged 4% monthly penal interest from the day start due

If the customer does not paid the installment within 6 days (on or before 21/05/2014) from the due date penal interest should be calculated as follows.

Loan Amount	<b>A</b>	24,000,000
Installement	<b>B</b>	63,201
Loan Interest rate	<b>C</b>	8%
Installement due date	<b>E</b>	9/15/2014
Install. Paid date	<b>F</b>	9/25/2014
No of days	<b>G = F - E</b>	10
Penal interest rate	<b>H</b>	4%
Penal interest	<b>B * H / 30 * G</b>	842.68

Company does not recognize penal interest amount (842.68) for loan lease products under accrual basis. It is recognized as an income once cash receipt. Cash basis penal interest recognition is an industry practice in bank and finance field. According to the Shariah law company cannot earn interest income and penal interest from their business activities. They should use received money from penal interest for charitable purpose. It has created liability to send

received money for charitable activities which are decided by sharia board. Company has used below entry once they collect cash.

Cash Book – Dr 842.7  
Charity fund (Liability) – Cr 842.7

Generally, charity fund is an account which is credited by the penal interest charged for the Islamic facility holders (Ijarah, Murabah) when they are paying cash, their respective monthly rental. Thus auditors have figure out that the penal interest income which should be recognized as an income separately then company can create the expense again. The present practice set off an expense with an income. It has been violated the financial reporting framework and LKAS 1.

## **Conclusion and Recommendation**

According to guidelines of LKAS 18 paragraph no 5 (a)  
“Charges for the use of cash or cash equivalents or amounts due to the entity should recognize as interest income.”

Therefore as per our opinion though company doesn’t use accrual basis as a best practice in the industry it should be recognized the penal interest as income once cash received. Required entries have been outlined below.

Cash Book – Dr 842.7  
Default interest income – Cr 842.7

Company can create the liability

Donations expense – Dr 842.7  
Liability for Charity – Cr 842.7

According to LKAS 1 (paragraph no 32)  
“An entity shall not offset assets and liabilities or income and expenses unless required or permitted by a SLFRS.”

If company didn’t pass above double entries it has violated the paragraph no 32 and they have offset the income and expenses of the company.

After changing to the present practice company can comply with the standard requirements. Other than that company should pay tax on the penal interest.